IMF

SURVEY

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IMF's Anniversary Marked by Response To Crisis, Rethinking of its Role

Since its foundation fifty years ago, the IMF has continually adapted to a changing world environment—preserving its essentially monetary and catalytic nature, while at the same time responding to the evolving needs of its membership. As the recently released *Annual Report 1995* of the IMF's Executive Board notes, the IMF's fiftieth anniversary year provided an occasion to reflect on past progress and an impetus to introduce initiatives and reforms aimed at enhancing the IMF's work in the future.

ANNUAL REPORT 1995

The IMF's anniversary year was also marked by a considerable increase in all areas of its operations. The single dominant event was the financial crisis in Mexico, to which the IMF responded with the largest amount of financial help ever extended to an individual member country. In addition, the IMF approved substantial arrangements for two major economies in transition—Russia and Ukraine—provided additional assistance to Argentina, extended financial support to a large number of other countries, and increased access to its financial resources for all members.

The Mexico operation and other developments had important implications for the future role of the IMF in a world characterized by integrated capital markets and highly sensitive investor behavior. In particular, as the Annual Report notes, the operations of the IMF over the medium term will depend on the strength of its surveillance function over its members' exchange rates, its monitoring of the international monetary system and ability to deal effectively with crises that may arise, and on the adequacy of its resources to support these roles. *(Please turn to the following page)*

Managing Risk in a New Financial Environment

The IMF's annual review of developments in capital markets focuses on two issues: turbulence in emerging developing country markets and the implications of the December 1994 financial crisis in Mexico for other emerging markets; and the challenges for international financial supervisors and regulators posed by the continuing growth of international derivative markets and their impact on the activities of the major money-center banks. (See the June 19 issue of the IMF Survey *for an overview.)*

The IMF report on capital markets also includes self-contained background papers. This article concentrates on the background papers pertaining to supervisory and regulatory issues.

In the last few years, the traditional activities of banks and the financial environment in which they operate have undergone fundamental and pervasive changes. Banks now actively participate in one of the *(Please turn to page 272)*

Strengthening Surveillance

Among the IMF's most important responsibilities is to oversee the effective functioning of the international monetary system and to exercise firm surveillance over members' exchange rate policies. The IMF fulfills these oversight and surveillance functions through regular consultations with individual member countries and, in a global context, through semiannual Executive Board discussions of the World Economic Outlook.

Article IV Consultations. Regular bilateral consultations between the IMF and member countries are mandated under Article IV of the IMF's Articles of Agreement. An IMF staff team visits a country, generally once a year, to gather economic and financial information and to discuss economic developments and policies with the country authorities. The staff team subsequently prepares a detailed report that is discussed by the IMF Executive Board. For each country, a summary of the Board discussion, compiled by the Chairman of the Executive Board, is transmitted to the country authorities.

The 1995 Annual Report features summaries for a large number of these Article IV consultations. For each country, the Annual Report also includes a brief description of salient macroeconomic and structural developments in the period leading up to the consultation.

Industrial Countries. During 1994/95, the recovery of world economic activity from the global slowdown of 1990–93 became firmly established. Growth among the industrial countries averaged 3 percent, with strong recoveries in the United States, Canada, the United Kingdom, Australia, New Zealand, and much of continental Europe; and a weaker recovery in Japan. A common issue for most industrial countries was the need for fiscal consolidation to reduce budget deficits. For many European countries, unemployment was also of considerable concern.

Developing Countries. The Executive Board held nearly 100 consultations with developing countries in 1994/95. Many countries—ranging from newly industrialized to low-income—had made significant and encouraging advances in macroeconomic and structural reforms, often with the financial support of the IMF. Their strong aggregate performance, however, masked considerable diversity, and most countries required some further macroeconomic and structural adjustment. In the course of the consultations, a number of developing countries were asked to improve the quality, coverage, timeliness, and transparency of their economic and financial data—in some cases, with technical assistance from the IMF.

Economies in Transition. The IMF's surveillance of transition economies covers three groups of countries: central and eastern Europe and the Baltic countries, Russia, and the other countries of the former Soviet Union.

In 1994/95, virtually all of the countries in the first group had embarked on serious stabilization and reform efforts. In those that had adopted more advanced programs—Albania, the Czech Republic, Poland, and Slovenia—inflation was declining rapidly, while their economies were expanding at a pace approaching or exceeding average growth in the European Union. These countries had also adopted outward-oriented strategies and had taken major strides toward integrating themselves into the global market economy. Fiscal imbalances, although showing marked improvement in the more advanced central and eastern European economies, remained relatively large; and inflation continued to pose a challenge.

Russia and the other countries of the former Soviet Union continued to be plagued by external and domestic instabilities in 1994. Of particular concern was the lax stance of fiscal policy throughout the region. Although a few countries had made a promising beginning in advancing structural reform, additional steps would have to be taken to ensure an effective transition from a state-run to a market-oriented economy. In general, the Executive Board warned against gradual approaches to reform and stabilization.

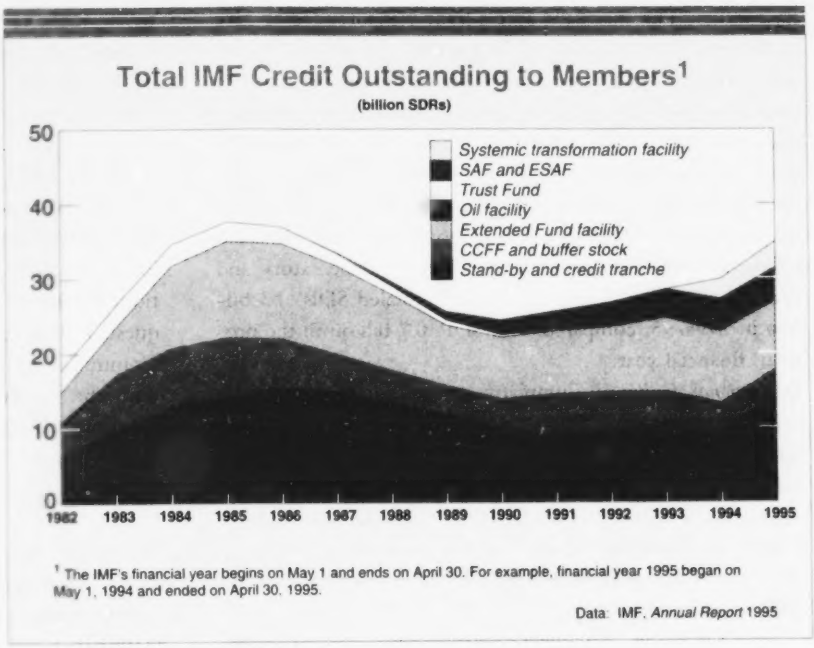
Biennial Surveillance Review. In 1995, the Executive Board's biennial review of surveillance was held against the background of increased globalization of capital markets and the greater mobility of capital flows across borders. In particular, the financial crisis in Mexico in December 1994 had demonstrated the swiftness and intensity with which international capital markets could react to adverse developments in a country.

In its 1995 review, the Executive Board examined ways to enhance the effectiveness of surveillance and to improve the IMF's policy dialogue with its members. There was general consensus on the following measures:

- establish a closer and more continuous policy dialogue with member countries, including candid assessments of possible risks attached to members' policies;
- ensure that member countries provide data to the IMF on a timely basis, so that the IMF can identify emerging tensions at an early stage;
- encourage the timely publication by members of comprehensive data to impart greater transparency to their economic policies;
- give more attention to members' financial policies and the soundness of their financial sectors, in view of the risks of overreliance on easily reversible capital flows; and
- focus surveillance more sharply on those members whose economic disturbances or policies are likely to have a

widespread effect on the international community.

International Policy Coordination. In the context of enhancing the effectiveness of multilateral surveillance, the Executive Board examined a number of systemic issues concerning international policy coordination. Most Board members viewed the mutual exchange of information, discussion, and persuasion—rather than explicit commitment to a formal system of policy coordination—as the main avenue for improving economic policies. There was general agreement that the primary focus of such policy cooperation should be the correction of policy fundamentals, and that only through stable domestic prices and fiscal consolidation could the major industrial countries durably enhance the future stability of key currencies. It was also agreed that in the exercise of its surveillance role, the IMF needed to monitor closely and assess carefully actual or emerging exchange rate misalignments.



[1] The IMF's financial year begins on May 1 and ends on April 30. For example, financial year 1995 began on May 1, 1994 and ended on April 30, 1995.

Data: IMF, *Annual Report* 1995

Exchange and Payments System. Issues involving the international exchange and payments system constitute the core of the IMF's traditional surveillance responsibilities. The accelerated progress made in 1994 by many members toward liberalizing their exchange system was a signal of their commitment to an open policy stance. As of April 30, 1995, 101 members had accepted the obligations of Article VIII (that is, full current account convertibility, whereby a member agrees not to impose restrictions on the making of payments and transfers for current international transactions).

Although the IMF does not have formal jurisdictional responsibilities over capital controls, its surveillance of members' exchange rates does extend to capital account transactions. Because of the predominance of capital transactions in today's economic landscape, some Executive Board members—at a November 1994 session on issues in the international exchange and payments system—expressed support for extending the IMF's jurisdiction in the area of capital account transactions. Some others, however, were reluctant, noting that in some circumstances capital controls could play a useful role in dealing with exchange rate pressures and the risk of destabilizing capital flows.

Financial Operations and Policies

Mexico Crisis. The IMF responded swiftly to a severe crisis that erupted in Mexico's financial and foreign exchange markets in December 1994 by approving an 18-month stand-by arrangement for SDR 12.1 billion (about $18 billion), including a contingent amount of SDR 6.8 billion. This exceptional action was taken in support of the Government's 1995–96 strong economic and financial adjustment program designed to deal with the crisis. Quick action by the IMF and its membership was also necessary to stop the spread of contagion effects arising from the crisis in Mexico.

Financial Activity in 1994/95. Commitments of IMF financial resources were at record levels in 1994/95, as the IMF moved rapidly to provide assistance to Mexico, Algeria, Argentina, and other developing countries; and also to Russia, Ukraine, and other countries in transition (see chart). Commitments under stand-by and extended arrangements totaled SDR 15.4 billion during the year (excluding the contingent SDR 6.8 billion for Mexico in June 1995). This exceeded the record SDR 14.1 billion committed at the height of the debt crisis in 1983. Drawings from the General Resources Account (GRA) totaled SDR 10.6 billion, twice the level of 1993/94. Of this total, SDR 7.6 billion represented drawings under stand-by arrangements, including the initial drawing by Mexico of SDR 5.3 billion. Repayments to the GRA during 1994/95 amounted to SDR 4.0 billion, compared with SDR 4.3 billion in the previous financial year.

Access Limits. In October 1994, the IMF's Executive Board increased for three years the annual access limit for drawings from the GRA from 68 percent to 100 percent of a coun-

try's quota. The increased access limit was intended to give confidence that the IMF could respond quickly and on an appropriate scale in support of strong economic programs.

Special Facilities. Since the inception of the systemic transformation facility (STF), which was created to respond to the needs of economies in transition, 20 members have drawn on the facility. In 1994/95, drawings from the STF by 12 members totaled SDR 1.1 billion, compared with SDR 2.7 billion in 1993/94. Drawings under the compensatory and contingency financing facility (CCFF) totaled SDR 0.3 billion in 1994/95, compared with SDR 0.7 billion in the previous financial year.

Concessional Facilities. Cumulative commitments under the structural adjustment facility (SAF) and the enhanced structural adjustment facility (ESAF) amounted to nearly SDR 7 billion at the end of the financial year, compared with SDR 6 billion a year earlier. The enlargement and extension of the ESAF Trust became effective in February 1995 and is being supported by a broad cross-section of the IMF's membership.

Overdue Obligations. The level of outstanding overdue obligations to the IMF rose slightly in 1994/95 to SDR 3.0 billion from SDR 2.9 billion in 1993/94. The number of countries in arrears to the IMF by six months fell from nine to eight, as Haiti eliminated its overdue obligations in December 1994.

Strengthening the IMF's Financial Resources. The developments in Mexico and Argentina in late 1994 and early 1995 and the IMF's commitment to support the adjustment programs of a number of economies in transition resulted in exceptionally large demands on the IMF's resources. These demands also heightened the importance of monitoring the IMF's liquidity position in the period ahead.

As the Annual Report notes, the IMF's liquid resources—total holdings of SDRs and usable currencies—had begun to weaken, falling from SDR 68.7 billion in April 1994 to SDR 61.6 billion in April 1995. Although the current liquidity position was deemed adequate, it was projected to decline sharply over the next two years. In light of this projected decline, the Interim Committee (of the Board of Governors on the International Monetary System), the IMF's principal advisory body, asked the Board to continue to review the adequacy of the IMF's resources. In connection with its review of the role of the IMF, the Committee asked the Board to carry forward its work on the Eleventh General Review of Quotas. The Interim Committee also saw a need to examine the issues related to borrowing by the IMF from members—in particular, the role of the General Arrangements to Borrow (under which 11 industrial countries or their central banks stand ready to lend up to SDR 17 billion to the IMF, with an additional SDR 1.5 billion under an associated arrangement with Saudi Arabia).

SDR Allocation. The Executive Board continued to study the issue of a new SDR allocation and discussed the long-term global need to supplement global reserves, the economic and monetary effects of a new allocation, the future of the SDR as a reserve asset, and the need to address the situation of new IMF members that had not participated in previous allocations. Although the Board did not agree on an allocation, the Interim Committee, in its 1995 communiqué, requested that the matter be kept under review. The Committee further asked the IMF to initiate a broad review, with the involvement of outside experts, of the role and functions of the SDR in light of the changes in the world financial system.

Increased Openness

In recent years, international organizations, commercial banks, academics, nongovernmental organizations, and the general public have looked to the IMF as a source of information not readily available elsewhere. In summing up the Executive Board's biennial review of surveillance, the IMF's Managing Director raised the issue of openness. He pointed to the need to strike a balance between preserving the confidential relationship between the IMF and its members and the desirability of encouraging more openness with the public about IMF policies and operations and the data on which they are based.

The IMF has responded through an expanded external relations and publications program and the development of information-sharing arrangements with several other international agencies. Also, in 1994, the Executive Board decided to make available to the public information contained in IMF documents—for example, recent economic development reports and statistical annexes that serve as background to the IMF's consultations with members, provided the member does not object. By April 30, 1995, 46 such documents had been released.

With the accession to membership of Eritrea in July 1994, the IMF's membership as of April 30, 1995, totaled 179 countries. ■

The *Annual Report 1995* is published in English, French, Spanish, and German. Copies are available free from Publication Services, Box XS500, International Monetary Fund, Washington, DC 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org.)

IMF Tasks and Decision-Making Shaped by Changing World

Leo Van Houtven, Secretary of the IMF and Counsellor, has been Director of the IMF's Secretary's Department since 1977. On August 17, he spoke with the Editor of the IMF Survey *about the evolution of the IMF, the roles of its Executive Board and staff, and decision-making at the IMF.*

IMF SURVEY: *Much of your work is with the Executive Board. How does the Board reach decisions and how does your department help develop the IMF's work program?*

VAN HOUTVEN: From my observation, decision making in the IMF is almost always the outcome of a search for common ground among a global membership—a search that involves the Board, the staff, and the Managing Director. The staff prepares the documentation on which the Board deliberates, with the Managing Director chairing the discussions. In the Board, members listen carefully to their colleagues. The strength of argument is a powerful tool. In fact, the resulting "peer pressure" can prove to be greater than the strength of a member's voting power. As the debate goes on, positions are often adjusted to facilitate movement toward common ground. Formal voting is rare; instead, in concluding the debate, the Chairman articulates the "sense of the meeting."

The Articles of Agreement give the IMF jurisdiction over matters that are critical attributes of sovereign nations. Surveillance over exchange rates, economic policies, and the use of IMF resources are issues that touch the central nerves of government. Not surprisingly, member governments have been determined to remain closely involved in IMF decision-making. Thus, when important issues are on the agenda, a good deal of "healthy tension" may develop among Board members, between Board members and staff, and with the Managing Director. And it may take several rounds of discussion to develop positions with which all, or most, are comfortable. Sometimes it appears impossible. Last year, for example, we were unable, first in the Board and then in the Interim Committee meeting in Madrid, to reach agreement on the issue of an SDR allocation. And yet the search for an acceptable resolution of this matter continues. I feel reasonably confident that in the end it can be achieved. It is part of our tradition.

You asked also how the work program of the Executive Board is developed. I see the process as a continuum. A number of items, such as in the area of multilateral surveillance, Article IV consultations with members, and requests for the use of IMF resources by members are recurrent and predictable. In the policy area, the ministerial meetings—notably, the Interim Committee and the Annual Meetings—each time lead to a number of requests to develop policy initiatives or adapt the ways in which the IMF assists its members. Other work is undertaken at the initiative of the Managing Director, the Executive Board, and the staff. All this is brought together twice a year in work programming exercises, immediately following the ministerial meetings. These exercises provide an opportunity for the institution to review and modify its priorities and to reconcile workload demands with the constraints on available resources. I think the work programming has sharpened the IMF's ability to manage crises, shortened its operational response time, and strengthened its focus on systemic issues.

Van Houtven: Decision-making in the IMF is the outcome of a search for common ground among a global membership.

IMF SURVEY: *The IMF has become a global institution with virtually worldwide membership. Has the increase in the IMF's membership and in the size of the Board affected its deliberations and the exercise of effective surveillance?*

VAN HOUTVEN: Until about four years ago, our institutional knowledge of the Baltics, Russia, and the other countries of the former Soviet Union was sorely lacking and our expertise on transition economies more generally was modest. Since then, an overwhelming effort has been made to acquire the knowledge needed to fulfill our tasks of assisting these countries in their transition to market economies. The number, and the quality, of research and policy papers produced by IMF staff on these economies in recent years is remarkable. It has also been a fast learning track for the Board.

The workload in recent years has been heavy, not only as a result of the additional membership but also because of a growing number of tasks. The

Board meets most Mondays, Wednesdays, and Fridays, often both mornings and afternoons. Indeed, in recent years, total Board meeting time has averaged around 500 hours a year. Board members must be available to meet "in continuous session" in response to work pressures. The Board has given increased importance to setting work priorities and to streamlining procedures for Board deliberations. In this regard, some Executive Directors would like the Chairman to be more interventionist in Board debates and to stand ready to conclude the debate. Other Directors, however, attach great importance to the principle of unrestrained debate, which they see as critical to IMF decision-making.

Each Board member has an Alternate Director and is assisted by a small staff of Advisors and Technical Assistants. Nevertheless, the continuing contacts with the home authorities and the resulting travel schedules add much to the responsibilities of Board members. While eight Directors are appointed or elected by one country, the other 16 Directors are elected by groups of countries—so called constituencies—which now average approximately 11 countries. Thus, the total tasks of Board members—as Executive Directors of the institution and as elected or appointed representatives of member countries—are very heavy. Still, Board members traditionally make considerable effort to be available in person to participate in deliberations on important agenda items.

IMF SURVEY: *A stronger role for the Interim Committee was discussed at the meeting in Madrid. What advantages would result, and how can this be accomplished?*

VAN HOUTVEN: Since its creation in 1974, the Interim Committee—whose composition parallels that of the Executive Board—has been closely involved in all the critical issues on the IMF's agenda. The Committee's views have been very important in shaping and resolving many issues. It has come to fulfill a role that the Board of Governors, because of its size, could no longer handle.

Van Houtven: The Interim Committee has been closely involved in all of the critical issues on the IMF's agenda.

With regard to IMF surveillance, the Committee's contribution has been mainly through discussions of the World Economic Outlook. In addition, with the added emphasis on strengthening surveillance by the IMF, it is increasingly felt that the Interim Committee could make a more effective contribution by having its members bring peer pressure on each other to strengthen their countries' economic policies. In the spring of 1993, therefore, the Committee adopted a declaration for sustained global expansion. And in Madrid last fall, it followed up with a declaration on cooperation to strengthen the global expansion. These declarations are benchmarks against which the subsequent performance of members' economies, and the quality of their policies, can be analyzed and judged.

The Interim Committee is the only body at the global level where those with top responsibilities in the financial and economic field meet twice a year; I think it is really a minimum. The bilateral meetings among members and with the Managing Director on the occasion of the Committee meetings also offer an excellent opportunity to strengthen professional and personal ties.

IMF SURVEY: *There have recently been calls for greater transparency on the part of the IMF. What steps has the IMF taken in this regard?*

VAN HOUTVEN: The pressure for more accurate and more quickly available information continues to grow everywhere. This reflects not only the increased sophistication of economies, and the increased need for information by markets, including capital markets, but also the movement toward more open and democratic governments and accountability of public institutions.

The IMF has always published a great deal about its work and operations. In addition, we have begun disseminating to the public background papers to our Article IV consultation reports with member countries. We are also preparing to open our archives. The staff and the Board are currently engaged in an examination of issues concerning member countries' provision of data to the IMF for surveillance

and standards to guide members' publication of data to the public. Despite many years of collaboration on these issues between members and the IMF, serious weaknesses and gaps remain. It is a complex matter—not just because the statistical capabilities differ but also because of deep-seated cultural differences among societies, particularly with regard to public access to information. Nevertheless, our recent Board debates have revealed a very positive response to the issues. Many member countries are now making considerable effort to narrow the information gaps. I believe the climate is right for us to press forward. I expect that the Interim Committee will strongly encourage us in this direction. Of course, we need to protect the confidentiality of our policy dialogue with member governments. I believe that as more and better information becomes promptly available, the apparent conflict between openness and confidentiality will subside.

IMF SURVEY: *The fiftieth anniversary of Bretton Woods has stimulated a review of the IMF's performance and mandate. From your perspective, as one of the longest serving senior officers of the IMF, what are key developments in the IMF's evolution?*

VAN HOUTVEN: One overarching aspect is the successful manner in which the IMF has adapted over the years to vast changes in the global environment. Similarly, it has built an outstanding record as an international crisis manager. But to answer the question more fully, I would focus on three broad developments, or stages, in the IMF's evolution.

In the early days of the IMF, our predecessors showed a great deal of foresight and vision. When they defined and organized the system of annual IMF consultations with member countries mandated in the Articles of Agreement, they laid the foundation for what would evolve into IMF surveillance. In addition, the basic policy framework on member countries' use of IMF resources that was developed in the early 1950s has stood the test of time. Similarly, a small research staff undertook a prodigious amount of critical research—especially on balance of payments issues, exchange rates, and monetary policy—a good deal of which remains relevant today. Finally, the respective responsibilities and work methods of the staff and the Executive Board, which were clearly defined in the early years, continue to serve the institution well today.

Second, let me pause for a moment on the period of "stress and strain" that began in the late 1960s and lasted until the early 1980s. In the late 1960s, our member countries' quest for continued increases in living standards and employment was so strong that price stability was neglected and inflation expectations became ingrained. With the subsequent demise of the Bretton Woods system, the IMF and its members lost their beacons of internal and external stability. In the ensuing years, many countries emphasized policy accommodation and financing, rather than adjustment of imbalances. This policy failure laid the basis for the debt crisis of the early 1980s. Thus, we had a period of nearly fifteen years of inflation, slow growth, strains among the membership, and monetary disorder. We have learned important cautionary lessons from this period.

Indeed, in the past decade or so we have witnessed the restoration of relatively low inflation in many countries, and the global economy appears poised for further balanced growth. Also, we have seen the emergence over the past decade of a broad consensus among the membership as to what constitutes the right policies. There is no serious dissent today from the need for disciplined monetary and fiscal policies to achieve durable growth and for structural reforms to promote flexible, efficient, and open economies. We have also learned to pay greater attention to the social dimension of adjustment and to the need for broad political and electoral support for successful adjustment. All of this, I feel, has strengthened the "glue" among the membership.

IMF SURVEY: *Looking ahead to the next half century, what do you think will be the long-term impact on the IMF of the globalized economic environment, the increased integration of economies, and the growth of capital markets?*

VAN HOUTVEN: I should duck every question about the next half century because it is difficult enough to look around the corner. Nevertheless, a few points stand out. Although the world economy is poised to achieve continued solid growth with reasonable price stability, many challenges remain. First and foremost is the need for job creation everywhere. Next, our experience from the late 1960s to the early 1980s taught us that we should never relax our commitment to the anchors of internal and external stability. On the latter, I am encouraged by the recent concerted action to achieve more viable exchange rate relationships among the three major currencies.

In a globalized economy with unrestrained, if not unrestrainable, capital mobility, the requirements of policy discipline increase sharply; otherwise, markets are likely to enforce discipline. This brings us back to the paramount need to strengthen IMF surveillance. Surveillance remains our prime task. Similarly, in a globalized economy with capital mobility, the IMF's capacity as a crisis manager needs to be sharpened further. In this regard, I look forward to the early establishment of an emergency financing mechanism in the IMF, as well as to rapid progress with the Eleventh General Review of Quotas and with improved borrowing arrangements by the IMF. These issues will no doubt figure prominently on the agenda of next month's meeting of the Interim Committee. ■

Banks Face Supervisory, Regulatory Challenges

(Continued from front page) fastest growing markets in the financial world: derivative markets, especially the largely unregulated over-the-counter (OTC) derivative markets. At the same time, new products and pricing and risk-management techniques are being introduced continuously. Furthermore, the increasing international integration of financial markets and recent advances in communications technology have greatly increased the potential for a financial crisis to spread not only across national systems but across international borders as well.

These changes have presented the banking industry with formidable challenges. In a series of background papers included in the IMF's annual review of developments in capital markets, IMF staff take an in-depth look at the major supervisory and regulatory issues that confront the banking industry today.

Capital Adequacy and Internal Risk Management

Recent advances in technology, the rapid growth of OTC derivative markets, the shift in banking activity from lending to heavy involvement in these markets, and the globalization and liberalization of financial markets have a number of important implications for the regulation and supervision of banking activities. In particular, the financial services industry has undergone a number of fundamental structural changes:

- Market and operational risk have become more important for banks (see box on page 273).
- Linkages between financial markets and institutions have strengthened.
- Banks now have the ability to change their portfolios and risk exposures quickly.
- Financial market conditions and the value of bank portfolios can change rapidly.

In response to these structural changes, regulators and leaders in the financial industry have been searching for a more relevant set of regulatory

Markets for Selected Derivative Financial Instruments: Notional Principal Amounts Outstanding

(billion U.S. dollars, end-year data)

	1986	1987	1988	1989	1990	1991	1992	1993	1994
Interest rate futures	370.0	487.7	895.4	1,200.8	1,454.5	2,156.7	2,913.0	4,942.6	5,757.4
Futures on short-term interest rate instruments	274.3	338.9	721.7	1,002.6	1,271.1	1,906.3	2,663.7	4,616.7	5,401.8
Three-month Eurodollar[1]	229.5	307.8	588.8	671.9	662.6	1,100.5	1,389.6	2,178.7	2,468.6
Three-month Euro-yen[2]	—	—	—	109.5	243.5	254.5	431.8	1,080.1	1,467.4
Three-month Euro-deutsche mark[3]	—	—	—	14.4	47.7	110.0	229.2	421.9	425.7
Futures on long-term interest rate instruments	95.7	148.8	173.7	198.2	183.4	250.4	249.3	325.9	355.6
U.S. Treasury bond[4]	23.0	26.5	39.9	33.2	23.0	29.8	31.3	32.6	36.1
Notional French Government bond[5]	2.1	7.6	7.0	6.1	7.0	11.4	21.0	12.6	12.7
Ten-year Japanese Government bond[6]	63.5	104.8	106.7	129.5	112.9	122.1	106.1	135.9	164.3
German Government bond[7]	—	—	1.4	4.2	13.7	20.2	27.8	33.3	41.7
Interest rate options[8]	146.5	122.6	279.2	387.9	599.5	1,072.6	1,385.4	2,362.5	2,622.7
Currency futures	10.2	14.6	12.1	15.9	16.9	17.9	24.9	32.2	33.0
Currency options[8]	39.2	59.5	48.0	50.2	56.5	62.8	70.9	75.4	54.5
Stock market index futures	14.5	17.8	27.1	41.3	69.1	76.0	79.7	109.9	127.7
Stock market index options[8]	37.8	27.7	42.9	70.6	93.7	132.8	158.6	238.3	242.4
Total	**618.3**	**729.9**	**1,304.8**	**1,766.6**	**2,290.2**	**3,518.8**	**4,632.5**	**7,760.8**	**8,837.8**
In the United States	517.9	577.7	950.3	1,152.3	1,263.0	2,132.1	2,675.5	4,324.9	4,754.9
In Europe	13.1	13.3	177.7	250.8	461.2	710.1	1,114.3	1,777.9	1,832.0
In Japan	63.5	107.7	106.6	260.9	424.2	441.2	576.1	1,193.5	1,498.2
In other countries	23.7	31.2	70.2	102.6	141.8	235.4	266.6	464.5	752.8

[1]Traded on the Chicago Mercantile Exchange-International Monetary Market (CME-IMM), Singapore Mercantile Exchange (SIMEX), London International Financial Futures Exchange (LIFFE), Tokyo International Financial Futures Exchange (TIFFE), and Sydney Futures Exchange (SFE).
[2]Traded on the TIFFE and SIMEX.
[3]Traded on the Marché à Terme International de France (MATIF) and LIFFE.
[4]Traded on the Chicago Board of Trade (CBOT), LIFFE, Mid-America Commodity Exchange (MIDAM), New York Futures Exchange (NYFE), and Tokyo Stock Exchange (TSE).
[5]Traded on the MATIF.
[6]Traded on the TSE, LIFFE, and CBOT.
[7]Traded on the LIFFE and the Deutsche Terminbörse (DTB).
[8]Calls plus puts.

Data: Bank for International Settlements

capital requirements. In the past few years, a consensus has begun to emerge about the most appropriate capital standard. An ideal standard, according to this consensus, should be:

- simple enough to be understood and implemented by all banks;
- as close as possible to a bank's internal risk management system;
- comprehensive enough to avoid distorting bank activities;
- built on a full portfolio approach;
- easily extendable to cover new products and new markets;
- applicable to all banks, regardless of their size and primary activities; and
- structured in a way that encourages improvements in internal risk-management.

An important implication of these ideal characteristics is that private internal risk management may be the foundation for ensuring the safety and soundness of individual financial institutions and in reducing systemic risk.

Revising Capital Adequacy Standards. The current international standards for bank capital requirements are derived from the Basle Accord of 1988. Formulated by the Basle Committee on Banking Supervision—which represents supervisory authorities from 12 major countries and operates under the auspices of the Bank for International Settlements—the 1988 Accord established for the first time an international framework for measuring regulatory capital and setting capital adequacy standards. Unfortunately, by the time the Accord came into force, the minimum standards it defined were already inadequate—partly because of changes in the nature of banking and in the financial services industry as a whole. Drafted at a time when banks were still concentrating on traditional banking functions, and when credit risk was the single most important risk factor, the Accord ignored market risk. Nor did it adequately cover many new OTC derivative products, most of which had not existed when the Accord was being drafted.

A Revolutionary Change. The difficulties the Basle Committee encountered in producing a new set of comprehensive capital adequacy requirements have prompted it to consider a revolutionary change in the way banks are supervised and regulated. On April 12, 1995, the Committee issued for comment a new set of capital requirements. The proposal could be adopted by the end of 1995 and implemented by the end of 1997. It moves bank regulation in a new direction by allowing banks to actively participate in the design of the framework for establishing capital requirements by using their own internal-risk management models to estimate value-at-risk. (Value-at-risk, the Basle Committee's standard measure for risk exposures, is an estimate of the maximum loss in the value of a portfolio or financial position over a given time period, with a built-in probability that the actual loss will not exceed a prespecified maximum).

The Basle proposal has several advantages for banks:

- It eliminates the need for banks to maintain two parallel systems—one for regulatory purposes and another for trading and portfolio allocation.
- It eliminates the distortionary effects of incomplete and rigid capital rules on bank activities.
- It promotes efficient updating of capital requirements to cover new products.
- It provides banks with additional incentives to improve their risk-management systems.

The new approach also poses many challenges. For one thing, there is little agreement in the banking industry about how to model and measure risk. Two banks holding the same portfolio could likely come up with different estimates of value-at-risk, implying different capital requirements for the same risks. Such an outcome violates a major objective of international capital requirements: the achievement of a level playing field.

Another problem with the new Basle approach is the emphasis on quantitative measures, such as value-at-risk, which might lead banks to miss major market events that are not easily quantifiable. The approach also ignores legal and operational risk—both important elements in recent financial crises (such as the failure of the U.K.-based investment bank, Barings). The uniform treatment of liquidity risk adopted by the Basle proposal might also be inappropriate, given differences in the instrument in question, the size of the position, and market conditions.

Risks Facing Banks

In today's high-powered and closely integrated financial world, banks face a multitude of complicated and interrelated risks:

Credit risk. The possibility that a counterparty might default on its position.

Market risk. A loss owing to unexpected general market price and interest rate changes.

Operational risk. A loss owing to human error, fraud, or lack of internal controls.

Legal risk. Associated with the legal status of a contract.

Liquidity risk. The possibility that a position cannot be sold quickly without a huge price concession.

Settlement risk. The market and credit risk exposure during the settlement period.

Specific risk. A decline in value of a particular position that is not the result of a general market movement.

Improving Internal Risk Management. Maintaining a minimum capital requirement is only one part of a bank's internal risk-management system, particularly given the heavy involvement of banks in the derivatives market. In July 1994, in recognition of the importance of high-quality risk-management systems for both banks and nonbanks, the Basle Committee on Banking Supervision and the International Organization of Securities Commissions issued joint reports on risk management. These reports itemize many important elements of sound risk management:

- Senior management must be involved in setting the overall policy of the firm.
- A line of authority and responsibility for managing risk and conducting derivative activities should be clearly established.
- Banks' internal auditors should evaluate compliance with risk limits.
- The reliability and timeliness of information reported to the bank's senior management and the board of directors should be emphasized.
- Risk should be measured and aggregated on an institution-wide basis, including both trading and nontrading activities.
- "Stress tests" should be conducted, including identification and likelihood of possible adverse events and an evaluation of the bank's ability to withstand the worst events.
- The institution should regularly review the underlying methodologies and assumptions of its models.

Transparency and Disclosure in The Derivatives Market

Derivatives markets have grown rapidly in recent years. Between the end of 1986 and the end of 1994, the total notional principal amount (the number by which the interest rates or exchange rates in a derivative contract are multiplied to calculate the settlement amount) of outstanding exchange-traded derivative contracts has grown at an annual average rate of 140 percent, from $0.6 trillion to $8.8 trillion (see table, page 272). OTC derivative markets have expanded at a similar pace. Between 1987 and 1993, the notional principal of outstanding interest rate and currency swaps grew from $1 trillion to $8 trillion, with nearly $2.4 trillion in transactions taking place in the second half of 1993 alone. The market in more complex swap-related OTC derivative products grew from $0.6 trillion at the end of 1990 to $1.4 trillion at the end of 1993.

Derivative instruments obtain their value from the value of the underlying securities, interest rates, or price indices. If used properly, derivatives are convenient and useful instruments for hedging against many kinds of risk and for unbundling risk so it can be distributed among those willing to incur it. But as the sudden collapse in early 1995 of Barings demonstrated, there is also a downside to dealing in derivatives. The Barings failure, which appears to have stemmed from a breakdown in its internal risk-management system, has heightened concerns about whether existing transparency and disclosure requirements for the derivative activities of banks are adequate for judging the safety and soundness of individual financial institutions and for safeguarding financial systems against systemic problems.

Active participation in OTC derivative markets, in particular, can reduce the transparency of an institution's financial condition and risk exposure for a number of reasons:

- OTC derivative positions are held as off-balance-sheet items, severely limiting the availability of information about a firm's derivative activities.
- Most accounting standards were established before the introduction of many OTC derivative instruments and were not designed to account for the risk exposures and income flows associated with them.
- The risk exposures of a derivative position cannot be assessed without knowledge of all related positions and the nature of the dynamic trading strategy employed.
- The value of derivatives can be sensitive to changes in the prices of the underlying securities, and the value of an institution's derivative portfolio can change rapidly.
- OTC derivatives are privately negotiated and custom designed, involving many counterparties in different countries.

Good information is essential for making trading and risk-management decisions. More information about Barings's derivative positions, for example, might have prevented the bank from accumulating positions that put its entire capital at risk. Lack of transparency can also lead to overreactions by market participants and prevent policymakers from making timely decisions about how to contain the effects of extreme events. Good information also helps investors make better investment decisions.

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
August 14	4.45	4.45	4.56
August 21	4.47	4.47	4.58
August 28	4.34	4.34	4.45
September 4	4.34	4.34	4.45

The SDR interest rate, and the rate of remuneration, are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (the U.S. dollar, weighted 40 percent; deutsche mark, 21 percent; Japanese yen, 17 percent; French franc, 11 percent; and British pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 102.5 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For latest rates, call (202) 623-7171.

Data: IMF Treasurer's Department

Challenges for Improving Disclosure. The major challenge, according to the IMF capital markets study, is to find a single measure of risk that captures comprehensively all the risks inherent in the financial activities of a single financial institution. An important impediment to greater transparency and disclosure is the absence of consensus about what information to disclose, when to disclose it, and to whom to disclose it. Recent initiatives have been undertaken by major financial industry and regulatory bodies (the Institute of International Finance, the Bank for International Settlements, and the U.S. Financial Accounting Standards Board) to improve transparency and disclosure. But, as the IMF study notes, these initiatives leave unresolved many issues, including:

Risk Aggregation. How to aggregate market and credit risk to obtain a comprehensive picture of a firm's risk exposure.

Nonquantifiable Risks. Liquidity, legal, and operational risks can be significant. The dearth of good measures of these risks makes it difficult for financial institutions to provide senior management, shareholders, and counterparties with accurate assessments of the riskiness of their portfolios.

Trade-off Between Uniformity and Flexibility. Incomparability makes it difficult for market participants to distinguish sound from less sound institutions, which can lead to massive and uniform withdrawal from all institutions in times of market turmoil. Rigid standards, on the other hand, cannot accommodate changes in market structure. Also, it might not be fair or feasible to impose the same standard on market participants from countries with different accounting and reporting standards.

Disclosure of Risk-Management System. Institutions are likely to use different risk-management systems and pricing models. Designing a common framework for reporting these systems presents a considerable challenge.

Other unresolved issues include frequency of reporting, how much disclosure is enough, who should report to whom, and the role of credit-rating agencies.

Wider Applications. Most of these challenges relate to information that can be used to assess the safety and soundness of an institution. But market-wide information on derivatives—"macro-disclosure"—is equally important. Armed with such comprehensive data, policymakers could assess the potential of a market disturbance to create a systemic problem in the derivative markets; and regulators and market participants could properly assess risk and act on these assessments during a crisis. However, according to the IMF study, no such comprehensive data exist, chiefly because the data across a broad range of financial institutions and across different countries are not comparable.

Investors and end-users of OTC derivative products are also relatively unprotected from legal and operational risk, as well as from fraud. Most end-users are dependent on major dealers whose in-house technical experts have access to the sophisticated mathematical models, proprietary data, and high-powered computers needed to create and price complex products. The custom-designed nature of OTC products also means there is little likelihood of a secondary market for many of them.

Some attempt has been made to address these concerns through the establishment of general rules of conduct for dealers and end-users. In recent months, codes of conduct have been proposed by the Federal Reserve Bank of New York, the Derivatives Products Group (made up of six major securities firms), and the International Swaps and Derivatives Association.

International Cooperation. Private internal risk management has come to be recognized as the foundation for ensuring the safety and soundness of individual financial institutions and in reducing systemic risk. But the prevention and containment of systemic problems also require the cooperation and coordination of supervisory and regulatory authorities across national boundaries. Among the multilateral banking supervisory organizations, the Basle Committee on Banking Supervision is the most widely recognized, although its recommendations are not binding. In contrast, the supervisory directives of the European Union are binding on its member states.

Other multilateral organizations include the International Organization of Securities Commissions, the only primary multinational securities firm supervisory organization; and multilateral private organizations, such as the Group of Thirty and the Institute of International Finance.

Bilateral cooperation, although less visible, also provides a useful channel for exchange of information among supervisors. Informal bilateral communication among central banks and bank supervisors is the predominant form of bilateral information; because it is flexible and timely, it is invaluable when crisis management is needed. ■

International Capital Markets: Developments, Prospects, and Key Policy Issues, by a staff team from the IMF's Research Department, is part of the IMF's World Economic and Financial Surveys series. Copies are available for $20.00 ($12.00 for full-time students and faculty members of colleges and universities) from Publication Services, Box XS500, International Monetary Fund, Washington, DC 20431 U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org.)

From the Executive Board . . .

CHAD: ESAF

The IMF approved a series of loans for Chad over the next three years under the enhanced structural adjustment facility (ESAF) totaling the equivalent of SDR 49.6 million (about $74 million), or 120 percent of quota, in support of the Government's 1995–98 macroeconomic and structural adjustment program. Of this total, the equivalent of SDR 16.5 million (about $25 million) will be disbursed in the first year in equal semiannual installments, the first of which is available on September 15, 1995.

For a long time, Chad's economy has suffered from recurring civil wars and a worsening of its terms of trade, developments that have caused a serious deterioration in the economic, social, and administrative infrastructure. In the early 1990s, internal strife resumed and the economy entered a period of severe weakening in public administration and decline in private sector activity that was aggravated by a growing overvaluation of the regional currency, the CFA franc. The authorities took advantage of the devaluation of the CFA franc in January 1994 to restart the economy by designing an economic adjustment program that was supported by an IMF stand-by credit and other external financing (see Press Release No. 94/17). After a weak beginning, economic and financial performance strengthened measurably with the program between July 1994 and June 1995, and the track record that was then established served as the basis for the formulation of a medium-term program that could be supported by the IMF.

Chad: Selected Economic Indicators

	1992	1993	1994[1]	1995[2]	1996[2]	1997[2]	1998[2]
				(percent change)			
Real GDP growth	6.1	-15.9	5.2	5.5	5.3	5.1	4.9
Consumer price index	-3.8	-7.0	41.3	6.5	4.5	3.0	3.0
				(percent of GDP)			
Current primary balance of the public finances (excluding grants)	-5.0	-6.2	-6.0	-2.2	-1.3	-0.4	1.2
External current account balance (excluding official transfers)	-21.9	-27.4	-22.7	-21.1	-21.1	-20.8	20.1

[1] Estimated
[2] Projected

Data: Chadian authorities and IMF staff estimates and projections

Program for 1995–98

The 1995–98 program, which is supported by the ESAF, seeks to achieve an annual growth in real GDP of around 5 percent, permitting some recovery in per capita income and helping to reduce poverty. In addition, the program aims to bring inflation down significantly to levels prevailing in key partner countries by the end of the program period. The fiscal and external current account deficits will also be reduced to more sustainable levels.

To these ends, the program will focus on: maintaining macroeconomic stability to foster private-sector development, safeguard external competitiveness, strengthen the saving-investment balance, and protect the most vulnerable groups in society from the transitional impact of some of these measures; improving the functioning of public administration, with emphasis on the efficiency and transparency of public sector financial management; reinforcing the revenue departments to ensure adequate domestic resource mobilization; revitalizing the private sector and strengthening the response mechanisms of the economy through privatization, price and trade liberalization, easing of market access, and a streamlining of the regulatory environment; and defining clear spending priorities, with a view to raising investment in human and physical capital.

Macroeconomic stabilization is to be pursued mainly through a reduction in public and private dissaving. In particular, the Government's current primary balance is to be turned to a surplus of 1¼ percent of GDP in 1998 from a deficit of 6 percent in 1994. Given

Use of STF as of July 31

(million SDRs)

Member	Amount Drawn	Percent of Quota [1]	Date of Drawings
Armenia	33.75	50	Dec. 19, 1994, July 3, 1995
Azerbaijan	29.25	25	Apr. 24, 1995
Belarus	140.20	50	Aug. 2, 1993, Feb. 2, 1995
Bulgaria	116.22	25	Apr. 14, 1994
Cambodia	6.25	10[2]	Oct. 7, 1993
Croatia	130.80	50	Oct. 19, 1994, April 13, 1995
Estonia	23.25	50	Nov. 1, 1993, Jan. 12, 1995
Georgia	55.50	50	Dec. 20, 1994, July 3, 1995
Kazakhstan	123.75	50	Jul. 28, 1993, Jan. 31, 1994
Kyrgyz Republic	32.25	50	May 17, 1993, Sep. 23, 1993
Latvia	45.75	50	Dec. 20, 1993, Jul. 20, 1994
Lithuania	51.75	50	Oct. 27, 1993, Apr. 13, 1994
Macedonia, former Yugoslav Republic of	24.80	50	Feb. 14, 1994, May 10, 1995
Moldova	45.00	50	Sep. 21, 1993, Dec. 22, 1993
Romania	188.53	25	May 16, 1994
Russian Federation	2,156.55	50	Jul. 6, 1993, Apr. 25, 1994
Slovak Republic	128.70	50	Jul. 29, 1993, Jul. 27, 1994
Ukraine	498.65	50	Oct. 31, 1994, April 12, 1995
Uzbekistan	49.87	25	Jan. 30, 1995
Vietnam	24.16	10	Oct. 6, 1993, Jun. 13, 1994
Total	**3,904.99**		

[1] Maximum access under the systemic transformation facility (STF) amounts to 50 percent of an eligible member's quota. Financing is made available in two equal disbursements, provided that conditions for such disbursements are met. Figures show gross disbursement.

[2] Percent of Cambodia's quota—SDR 25 million—effective at the time of the drawing.

Data: IMF, Treasurer's Department

pressing spending needs in a number of priority areas, the Government will pursue fiscal consolidation primarily through measures that broaden the tax base and strengthen revenue collection in the context of the regional tax and customs reform program of the Central African Economic and Customs Union (UDEAC), of which Chad is a member. Prudent monetary management will accompany fiscal policies. To strengthen market mechanisms, these policies will also aim to broaden the use of indirect instruments of monetary control.

Within this medium-term strategy, the program for 1995 envisages real GDP growth accelerating to 5.5 percent, from 5.2 percent in 1994; a reduction in the rate of inflation to 6.5 percent from 41.3 percent in 1994; and a further narrowing of the current account deficit to 21.1 percent of GDP from 22.7 percent in the previous year. To these ends, fiscal policy aims to reduce the current primary deficit to 2¼ percent in 1995 from 6 percent of GDP in 1994, in large part through improvements in revenue collection.

Structural Reform Policies

The principal objective of structural reform under the program is to revitalize and expand the size of the private sector. Accordingly, the Government plans to accelerate the privatization program and to strengthen the operations and market orientation of public enterprises. The authorities will also reform the Labor Code to increase the flexibility of labor markets; abolish import and export licenses to facilitate and stimulate trade and commerce; and streamline exchange regulations to remove uncertainties about, and lower the cost of, foreign exchange transactions. In addition, Chad will support and implement regional initiatives aimed at a simplification and harmonization of business laws and regulations. The authorities will also take measures to strengthen the budget process and initiate a comprehensive civil service reform. Finally, the program envisages an improvement in the flow and transparency of information on economic developments and policies to the business community and to the general public.

Social and Environmental Issues

Poverty reduction is the ultimate objective of Chad's economic program. The

Stand-by, EFF, SAF, and ESAF Arrangements as of July 31

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-by arrangements			**19,812.69**	**10,506.86**
Armenia	June 28, 1995	June 27, 1996	43.88	40.50
Cameroon	March 14, 1994	September 13, 1995	81.06	59.15
Croatia	October 14, 1994	April 13, 1996	65.40	52.32
Ecuador	May 11, 1994	March 31, 1996	173.90	75.00
El Salvador	July 21, 1995	September 20, 1996	37.68	37.68
Estonia	April 11, 1995	July 10, 1996	13.95	13.95
Georgia	June 28, 1995	June 27, 1996	72.15	66.60
Haiti	March 8, 1995	March 7, 1996	20.00	3.60
Kazakhstan	June 5, 1995	June 4, 1996	185.60	139.19
Latvia	April 21, 1995	May 20, 1996	27.45	27.45
Lesotho	July 31, 1995	July 30, 1996	7.17	7.17
Macedonia	May 5, 1995	June 4, 1996	22.30	19.80
Mexico	February 1, 1995	August 15, 1996	12,070.20	5,520.30
Moldova	March 22, 1995	March 21, 1996	58.50	39.15
Papua New Guinea	July 14, 1995	January 13, 1997	71.48	47.56
Poland	August 5, 1994	March 4, 1996	693.30	410.00
Romania	May 11, 1994	December 10, 1995	131.97	75.41
Russian Federation	April 11, 1995	April 10, 1996	4,313.10	2,875.40
Slovak Republic	July 22, 1994	March 21, 1996	115.80	83.65
Turkey	July 8, 1994	March 7, 1996	610.50	225.00
Ukraine	April 7, 1995	April 6, 1996	997.30	687.98
EFF arrangements			**8,008.81**	**3,484.78**
Algeria	May 22, 1995	May 21, 1998	1,169.28	1,012.88
Argentina	March 31, 1992	March 30, 1996	4,020.25	768.55
Egypt	September 20, 1993	September 19, 1996	400.00	400.00
Jamaica	December 11, 1992	December 10, 1995	109.13	22.38
Jordan	May 25, 1994	May 24, 1997	189.30	90.81
Lithuania	October 24, 1994	October 23, 1997	134.55	93.15
Pakistan	February 22, 1994	February 21, 1997	379.10	255.90
Peru	March 18, 1993	March 17, 1996	1,018.10	375.41
Philippines	June 24, 1994	June 23, 1997	474.50	438.00
Zimbabwe	September 11, 1992	September 10, 1995	114.60	27.70
SAF arrangements			**49.42**	**—**
Ethiopia	October 28, 1992	November 8, 1995	49.42	—
ESAF arrangements			**3,139.10**	**1,821.45**
Albania	July 14, 1993	July 13, 1996	42.36	11.30
Benin	January 25, 1993	January 24, 1996	51.89	9.06
Bolivia	December 19, 1994	December 18, 1997	100.96	84.14
Burkina Faso	March 31, 1993	March 30, 1996	53.04	17.68
Cambodia	May 6, 1994	May 5, 1997	84.00	56.00
Côte d'Ivoire	March 11, 1994	March 10, 1997	333.48	154.83
Equatorial Guinea	February 3, 1993	February 2, 1996	12.88	8.28
Ghana	June 30, 1995	June 29, 1998	164.40	137.00
Guinea	November 6, 1991	November 5, 1996	57.90	23.16
Guinea-Bissau	January 18, 1995	January 17, 1998	9.45	7.88
Guyana	July 20, 1994	July 19, 1997	53.76	35.84
Honduras	July 24, 1992	July 24, 1997	47.46	23.73
Kyrgyz Republic	July 20, 1994	July 19, 1997	70.95	47.30
Lao P.D.R.	June 4, 1993	June 3, 1996	35.19	17.60
Mali	August 28, 1992	March 31, 1996	79.24	14.73
Mauritania	January 25, 1995	January 24, 1998	42.75	35.63
Mongolia	June 25, 1993	June 24, 1996	40.81	16.70
Mozambique	June 1, 1990	December 31, 1995	130.05	14.70
Nepal	October 5, 1992	October 4, 1995	33.57	16.79
Nicaragua	June 24, 1994	June 23, 1997	120.12	100.10
Pakistan	February 22, 1994	February 21, 1997	606.60	404.40
Senegal	August 29, 1994	August 28, 1997	130.79	83.23
Sierra Leone	March 28, 1994	March 27, 1997	88.78	20.22
Togo	September 16, 1994	September 15, 1997	65.16	43.44
Uganda	September 6, 1994	September 5, 1997	120.51	87.04
Vietnam	November 11, 1994	November 10, 1997	362.40	302.00
Zimbabwe	September 11, 1992	September 10, 1995	200.60	48.70
Total			**31,010.10**	**15,813.08**

EFF = extended Fund facility.
SAF = structural adjustment facility.
ESAF = enhanced structural adjustment facility.
Figures may not add to totals owing to rounding.

Data: IMF, Treasurer's Department

Use of IMF Credit and Loans in July

(million SDRs)

	1995		1994
	July	January–July	January–July
General Resources Account	*1,747.60*	*10,497.57*	*3,341.59*
Stand-by arrangements'	1,682.27	8,671.17	826.46
EFF arrangements	20.70	1,293.80	636.83
CCFF	0.00	0.00	295.82
STF	44.63	532.60	1,582.48
SAF and ESAF arrangements	*27.40*	*292.28*	*505.67*
Total	**1775.00**	**10,789.85**	**3,847.26**

Note: EFF = extended Fund facility.
CCFF = compensatory and contingency financing facility.
STF = systemic transformation facility.
SAF = structural adjustment facility.
ESAF = enhanced structural adjustment facility.
Figures may not add to totals owing to rounding.
' Includes drawings in first credit tranche.

Data: IMF, Treasurer's Department

recovery of economic growth is to make the main financial contribution toward this objective. The rural population will continue to benefit from the correction of relative prices and incentives, and other measures and effects that followed the devaluation of the CFA franc. In addition to the general upturn in economic activity, the urban population is to benefit from temporary labor-intensive public investment schemes financed by donors. The social policy program also includes a substantial increase in budget allocations for basic health services, including the supply of essential generic drugs, and primary education.

Environmental problems arising from inappropriate cultivation practices and widespread deforestation pose serious threats to Chad's rural economic base. A new forest and wildlife policy was approved in late 1994 to deal with illegal timber felling and to promote a sustainable use of forest resources. The Government has also revised mining regulations in an effort to prevent the discharge of industrial waste into local water supplies. It is expected that the private sector and an environmental fund established by the Government in 1994 will bear the cost of repairing environmental damage.

The Challenge Ahead

Given its narrow production structure, Chad remains vulnerable to external shocks. It will, therefore, remain important to further strengthen the responsiveness of markets and the adaptability of economic sectors. Chad's long-term balance of payments prospects will also depend on maintaining competitiveness through appropriate wage and producer price policies and measures that raise long-term productivity.

Chad joined the IMF on July 10, 1963. Its quota is SDR 41.3 million (about $62 million). Its outstanding financial obligations to the IMF amount to the equivalent of SDR 27 million (about $40 million).

Press Release No. 95/44, September 1

Reducing Unproductive Spending Is Key to Public Sector Productivity

What are unproductive public expenditures, and how can they be identified? Why is it important to reduce them? How can policymakers evaluate and improve the productivity of public expenditures? A recent IMF study shows public sector productivity can be increased in all countries if policymakers support the formulation and execution of public expenditure policy through a systematic analysis of public sector production processes, including an assessment of the economic costs of achieving alternative objectives.

Analytical Framework

Maximizing the productivity of public expenditure depends on satisfying two conditions: the cost-effectiveness of individual public expenditure programs and the optimal output mix. Cost effectiveness entails the design and implementation of programs or projects to provide given levels of output or achieve specific objectives at minimum cost. An optimal mix of public sector outputs implies that the social benefits derived from public expenditure programs should be equalized at the margin. The authors of the study define "unproductive expenditures" as the difference between an actual level of expenditures yielding certain benefits and a reduced level of spending achieved under these conditions to yield the same benefits.

Implications of Unproductive Spending

Unproductive public expenditures arise because of many elements, including the pursuit of multiple objectives in public expenditure programs, uncertainty, the lack of a well-trained civil service, inadequate checks and balances in the political and budgetary process, and corruption. Unproductive

expenditures imply a larger fiscal deficit, a smaller public sector output, and/or a tax burden that is heavier than necessary.

Reducing unproductive public expenditures is especially important for countries that need to reduce speedily their fiscal deficits, as many governments in that situation find it difficult or impossible to raise revenue levels significantly in the short run. Even in countries without major fiscal imbalances or large public sectors, reducing certain inefficient categories of public expenditures would release resources to expand other critical public programs or to strengthen the fiscal position.

Reducing unproductive expenditures worldwide would yield a large increase in available resources. With public expenditures accounting for about 30 percent of world GDP as of the early 1990s, an increase in public expenditure productivity of 1 percent would release $90 billion in resources for additional public investment, social programs, or deficit reduction.

Analyzing Public Expenditure Productivity

Unproductive public expenditures can often be identified by articulating the primary objectives of a public expenditure program and comparing indicators of public sector outputs with costs. In some cases, an analysis of institutional arrangements can point indirectly to inefficient programs—for example, when budgetary control, the procurement system, project management, or auditing procedures are deficient. For those expenditures for which benefits can be quantified and compared with one another, a cost-benefit analysis may enable a government to increase total benefits by reallocating expenditures from those programs yielding smaller additional benefits to those yielding larger added benefits.

More broadly, it is important to analyze the macroeconomic and structural implications of expenditure policies, particularly the short- and longer-run effects of public expenditure programs on aggregate demand, resource allocation, financing, and external balances.

The IMF study provides a practical approach for assessing public expenditure productivity and illustrates the analysis of public expenditure productivity for major expenditure categories: public sector employment and wages; subsidies and transfers; public investment; nutrition, health, and education; and military expenditures.

The example of health and education expenditures demonstrates the usefulness of analyzing empirical data comparing main output indicators or their proxies with certain input or cost indicators. Educational attainment indicators—such as literacy rates, standardized test scores of students, and school enrollment ratios—can be compared with relevant measures of spending on education. For instance, high teacher-student ratios, in the absence of high educational attainment, may indicate inefficiency. Similarly, the infant mortality rate or life expectancy may be compared with health expenditures, and linkages between health indicators and certain types of health outlays can be assessed.

It is also often useful to examine the intrasectoral mix of programs while assessing the cost-effectiveness of public expenditures in meeting health and education objectives. For example, research in many countries indicates a higher social rate of return on public outlays for preventive health care, as opposed to curative hospital expenditures. This suggests that the cost-effectiveness of expenditures can be improved by reallocating spending in favor of preventive care. In education, the high rate of return on outlays for primary education, as opposed to university education, may also argue in favor of reallocating public resources.

Imbalances between categories of current expenditures can provide useful clues of inefficiency in health and education programs. Imbalances between expenditures on wages and salaries and other goods and services, for example, can result in a lack of supplies at health clinics, paralyzing their operations.

Public Expenditure and Economic Growth

Since many—although not all—public expenditure programs are aimed at stimulating economic growth, the effect of public spending on economic growth may be an indicator of public expenditure productivity. By pointing to a set of public sector outputs as particularly conducive to economic growth—as well as to the efficiency with which the expenditures contribute to public sector production—empirical studies on expenditures and growth can suggest ways to improve public expenditure composition and productivity. As the authors' survey of the literature shows, however, the empirical studies undertaken thus far have yielded conflicting results: some support the hypothesis that a rise in the share of public spending is associated with a decline in economic growth; others have found that public spending is associated positively with economic growth; and still others have found no significant relationship.

A number of studies support a positive relationship between various education expenditures and economic growth, while others point to the productivity of specific—as opposed to overall—education and health services, such as primary education, community health services, and preventive health care expenditures. As for military expenditures, the literature suggests that these outlays reduce economic growth

over the longer term by crowding out other more productive expenditures, including private investment. Interestingly, although the contribution of public investment to economic growth has invariably been assumed theoretically, empirical studies based on aggregate public expenditure data have found only weak links between public investment and economic growth.

Implications for Policymakers

The authors' consideration of the economic implications of unproductive public expenditures has, among other things, the following implications:

• A systematic economic analysis of public sector production processes aimed at improving the efficiency of public sector programs should support the formulation and execution of public expenditure policy.

• To make difficult choices related to public expenditure composition, it is important to assess the economic costs of achieving alternative objectives.

• For an effective reduction in military expenditures and producer subsidies for export products, international cooperation is crucial.

• Sound public expenditure analysis requires proper statistical data, including relevant comprehensive data on economic and functional expenditure components and subcomponents. The statistical data currently being collected are far from adequate.

The authors suggest a number of practical steps that policymakers could take to reduce unproductive expenditures:

• identify public sector outputs that can be provided or produced more efficiently by the private sector;

• examine whether the primary objective of the program is being met in the most cost-effective way, and ensure that secondary objectives do not dominate the primary objective;

• identify "white elephant" programs in both the recurrent and capital components of the budget by focusing on big-ticket items;

• examine generalized food or producer subsidies, with a view to generating savings in expenditures while retaining benefits for the poor in the short term;

• assess the adequacy or efficiency of particular social expenditures by comparing expenditure allocations—and achievement of objectives—with countries at the same level of development and in the same region;

• gauge expenditure productivity by examining budgetary allocations for wage and nonwage expenditures for different ministries or sectors, keeping in mind that low nonwage current expenditures, particularly in education and health sectors, indicate low expenditure productivity;

• analyze overall and sectoral employment, disaggregated by type of employee, to determine whether there is a shortage of skilled personnel at the middle and higher levels of the civil service or a surplus of unskilled employees at lower levels; and

• examine the accounts of extrabudgetary funds or the quasi-fiscal activities of the central bank. ■

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